2016 INVESTMENT MANAGEMENT CONFERENCE

ERISA For Investment Advisers

William A. Schmidt
Kristina M. Zanotti
OVERVIEW

- The Basics
- New Fiduciary Rule
- Fund Perspectives
- Disclosure Obligations
ERISA: THE BASICS
WHAT IS “ERISA”? 
- Employee Retirement Income Security Act 
- Federal law regulating benefit plans 
- State laws preempted 
- Other Federal laws (Advisers Act) apply
WHAT PLANS ARE COVERED BY ERISA?

- Corporate retirement plans
- Corporate “welfare” plans
- Union retirement/welfare plans
- “Taft-Hartley” plans
WHAT PLANS ARE NOT COVERED BY ERISA?

- Self-employed (“Keogh”) plans
- Individual retirement accounts

But, . . .

Internal Revenue Code Section 4975
WHAT PLANS ARE NOT COVERED BY ERISA?
(CONTINUED)

- Government plans
- Church plans
- Foreign plans
“FIDUCIARY” STATUS

The key ERISA concept

- Fiduciary status is “functional”
- Basic fiduciary functions include (but are not limited to):
  - Investment discretion
  - Investment advice (new DOL Fiduciary Rule impacts this)
FIDUCIARY DUTIES – GENERAL

 “Solely in the interest”; “exclusive purpose”
 Prudence; diversification
 Comply with plan documents
 Duty of disclosure – an evolving concept
 Avoid prohibited transactions
 Employer securities rules
CONSEQUENCES OF BREACH OF FIDUCIARY DUTY

- Restore “losses”
- Disgorge “profits”
- “Equitable relief”
- Excise tax under Code Section 4975
- “Correction” of prohibited transaction
FIDUCIARY DUTIES – PROHIBITED TRANSACTIONS

Two categories of prohibited transactions:

- “Fiduciary” prohibited transactions – transactions involving self-dealing or conflicts of interest by plan fiduciaries
- “Party in interest” transactions – transactions between a plan and a “party in interest” of the plan
“FIDUCIARY” PROHIBITED TRANSACTIONS

- Statutory prohibition against fiduciary self dealing and conflicts of interest
- General principles in DOL regulation
- Examples:
  - Compensation arrangements
  - Cross trades
  - “Kickbacks”
“PARTY IN INTEREST” PROHIBITED TRANSACTIONS

- Plan fiduciary may not cause plan to engage in any of following transactions if fiduciary knows or should know the transaction is with a “party in interest”:
  - Sale, exchange, lease
  - Loan, extension of credit
  - “Use” of plan assets for benefit of party in interest
  - Services
“PARTY IN INTEREST” PROHIBITED TRANSACTIONS

- Who is a “party in interest”?

*And*, certain affiliates and parties related to the persons described above.
New Fiduciary Rule
**OVERVIEW OF RULE**

- Greatly expands the number of market participants that are ERISA fiduciaries by reason of providing investment advice
- Doesn’t change “discretionary” fiduciary definition
- Advice is fiduciary investment advice if both (A) and (B) are met (No requirements of (i) regular basis, (ii) primary basis or (iii) mutuality):

<table>
<thead>
<tr>
<th>(A) Types of advice</th>
<th>(B) Type of advice provider</th>
</tr>
</thead>
<tbody>
<tr>
<td>“Recommendations” regarding acquiring, holding, disposing of, or exchanging, securities or other investment property, <strong>including recommendations about how property should be invested after a rollover</strong></td>
<td>Represents or acknowledges that it is acting as a fiduciary under ERISA or the Internal Revenue Code</td>
</tr>
<tr>
<td>“Recommendations” regarding the management of investment property, <strong>the selection of other persons to provide investment advice or management services</strong>, the selection of investment account arrangements, and recommendations regarding rollovers, transfers or distributions</td>
<td>Renders advice pursuant to an agreement, arrangement or understanding that the advice is based on the <strong>particular investment needs</strong> of the advice recipient</td>
</tr>
<tr>
<td>Directs the advice to a <strong>specific advice recipient</strong> regarding the advisability of a <strong>particular investment</strong> or management decision regarding plan assets</td>
<td></td>
</tr>
</tbody>
</table>
“RECOMMENDATION”

- Broadly includes statements that would reasonably be viewed as suggestions to take or refrain from taking a particular course of action
- Content, context and presentation inform the determination
- The more individually tailored the communication, the more likely it is a suggestion
- Consider promotional activities
CAN I AVOID FIDUCIARY STATUS?

- “Hire Me”
- Investment education
- General communications
- Transactions with independent fiduciaries with financial expertise (“Sophisticated Fiduciary”)
  - Retail vs. Institutional Investors
BEST INTEREST CONTRACT EXEMPTION

- Allows otherwise impermissible compensation
  - 12b-1 fees
  - Commissions
  - Sales loads
  - Revenue-sharing payments
  - BUT fees to sales people are limited
- Not available for non-“riskless” principal transactions
- Compliance Burdens: Many requirements, including
  - Compliance with “Impartial Conduct Standards”
  - Policies and procedures
  - Disclosures
- Streamlined requirements for “level fee fiduciaries”
Analysis Overview – Consider both “promotional” and “operational” activities

Am I talking to a covered person?

- IRAs, HSAs, U.S. corporate retirement plans, plan asset funds, ANOTHER FIDUCIARY

Am I making a covered recommendation?

- “Hire me”
- General communications
- Education

Is there an exclusion from fiduciary status?

- Transactions with “sophisticated fiduciaries”

If I am a fiduciary, is there a prohibited transaction?

- No fee no “(b)”, Frost Letter, SunAmerica

If there is a prohibited transaction, what exemption should I use?

- BIC Exemption – Full requirements
- BIC Exemption – Level-fee Fiduciary
- ERISA Section 408(b)(14)
- Principal Transactions, other
FUND PERSPECTIVE

- Mutual Funds
- Bank Collective Trusts
- Insurance Company Separate Accounts
- Private Investment (Hedge) Funds
DOES ERISA APPLY?
(ARE FUND ASSETS “PLAN ASSETS”?)

If fund assets are “plan assets” –

- Fund manager is an ERISA “fiduciary”
- Plans have “undivided interests” in all fund assets
- Fund transactions subject to ERISA restrictions, including prohibited transactions
- Exculpation, indemnity of fund manager limited
“PLAN ASSETS”? 

- Registered investment company – mutual fund or closed-end fund? NO
- Bank collective trust fund YES
- Insurance company pooled separate account YES
WHAT ABOUT PRIVATE (HEDGE) FUNDS?

The “25% Test” –

Assets of a private investment fund are treated as “plan assets” if benefit plan investors hold 25% or more of any class of equity interests in the fund – *not counting* any interests held by the fund manager or its affiliates for their own account.
THE NUMERATOR:
“BENEFIT PLAN INVESTORS”

- Defined in ERISA § 3(42):
  - Plans subject to ERISA
  - Plans subject to Code Section 4975
  - “Plan asset” funds
25% TEST – THE FORMULA

Numerator:
- ERISA plans
- plus Code 4975 plans
- plus “Plan-asset” funds (ERISA “portion”)

Denominator:
- Investments by all investors
  less investments by fund manager and “affiliates”

= 25% (or more) per class?
OVERVIEW

- Schedule C of Form 5500
  - Plan administrator discloses “Service Provider Information” to DOL
  - However, service providers expected/required to provide information to plan administrator on request.
- Service Provider Exemption/ERISA 408(b)(2)
  - Disclosures from Covered Service Providers to plan fiduciary under ERISA 408(b)(2) regulation
- Participant Disclosures
  - Disclosures from plan administrator to plan participants under ERISA 404(a)
  - However, plan administrators will request info from providers of “designated investment alternatives.”
## WHAT MUST BE DISCLOSED?

<table>
<thead>
<tr>
<th>Schedule C (Form 5500)</th>
<th>Service Provider Exemption/408(b)(2)</th>
<th>Participant Disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td>“Compensation” (money or “anything of value”), if ≥ $5000.</td>
<td>Services provided</td>
<td>Plan-related information</td>
</tr>
<tr>
<td>Direct compensation</td>
<td>Status statement</td>
<td>Information related to “Designated Investment Alternatives”</td>
</tr>
<tr>
<td>Indirect compensation</td>
<td>“Compensation” (anything of monetary value) – direct, indirect, termination, “offset” compensation</td>
<td></td>
</tr>
</tbody>
</table>

- Direct compensation
- Indirect compensation
CONCLUSION